In the Supreme Court of the United States

OCTOBER TERM, 1971

No. 71-1376

GEOGHEGAN & MATHIS, INC., PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The opinion of the Tax Court (Pet. App. 19-26) is reported at 55 T.C. 672. The opinion of the court of appeals (Pet. App. 27-33) is reported at 453 F. 2d 1324.

JURISDICTION

The judgment of the court of appeals was entered on January 28, 1972. The petition for a writ of certiorari was filed on April 25, 1972. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

QUESTION PRESENTED

Whether the court of appeals erred in holding that petitioner's $14,682.78 payment for relocation of a utility company's pipeline and right of way across petitioner's mineral tract was a capital cost of obtaining

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the right of access to mineral deposits, and thus neither a development expenditure deductible under Section 616(a) of the Internal Revenue Code of 1954 nor an ordinary and necessary business expense deductible under Section 162(a) of the Code.

STATUTES AND REGULATIONS INVOLVED

The pertinent statutes and Regulations are set forth in the petition and its Appendix (pp. 4, 34–38).

STATEMENT

In 1959, the petitioner, an operator of limestone quarries in Kentucky, purchased a fee interest in a tract of land under which commercially marketable quantities of limestone were known to exist. This purchase was subject to existing easements and restrictions, including a utility company's perpetual easement across the central portion of the tract for the construction and maintenance of a gas pipeline. (Pet. App. 27–28.)

From 1959, petitioner mined the tract, using the open pit method. As the vertical face of the pit moved in an eastern direction with the mining process, it came closer to the pipeline easement and pipeline. In order to permit the continuation of mining progress, petitioner entered into negotiations with the utility company which resulted in their joint execution of a "Grant and Release of Easement" on January 16, 1964, releasing the existing easement and granting a new easement circumventing the mining area. As part of the agreement, petitioner, in December, 1964, paid the cost of relocating the pipeline within the new right of way. In its federal tax return for its

1964 taxable year, petitioner deducted the full amount of the relocation expenditure as a development expenditure under Section 616(a) of the Code. On the theory that the cost of relocating the pipeline was a depletable capital expenditure, the Commissioner of Internal Revenue disallowed the claimed expense deduction. The Tax Court upheld the disallowance, and the court of appeals affirmed. (Pet. App. 28–29, 33.)

ARGUMENT

The decision below is correct. Although there is an apparent conflict of decisions, the decisions are factually distinguishable, the decision below was correctly decided, and the issue is not of sufficient administrative importance to warrant further review by this Court.

1. The Internal Revenue Code permits mining operators such as the petitioner to recover their capitalized mining costs through reasonable annual deductions for depletion, "to permit the owner of a capital interest in mineral in place to make a tax-free recovery of that depleting capital asset." *Parsons* v. *Smith*, 359 U.S. 215, 220; *United States* v. *Cannelton Sewer Pipe Co.*, 364 U.S. 76, 81. In addition, a mining operator may, under Section 616(a), take deductions for certain "development" expenses "incurred after the existence of * * * minerals * * * has been disclosed." The petitioner's contention is that the pipeline relocation expenditure was currently deductible as a development expense, or, alternatively, as an ordinary and necessary business expense.

The expense at issue here was incurred after marketable quantities of minerals were known to exist; the only question under Section 616, therefore, is whether the expense was within the scope of the term "development" as used in that section. Upon examination of the legislative history of Section 616, both courts below correctly concluded that the petitioner's pipeline relocation cost was not within the category of expenditures intended by Congress to be deductible under that section. The predecessor of Section 616 was enacted in 1951 not to create a new category of deductible mining expenses, but rather, to codify the deduction already allowed by the Commissioner for certain expenses known in the mining industry as development expenses, and to permit such deductions during earlier stages of the mining operation than was previously permitted.[1]

The courts below correctly held that Congress, by adopting the commonly understood meaning of devel-

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[1] Section 309(a), Revenue Act of 1951, c. 521, 65 Stat. 452, 486; codified as Section 23(cc) of the Internal Revenue Code of 1939. Prior to 1951, development expenses were permitted to be deducted currently only if incurred during the "production" stage of a mine's operation. Any such expenses incurred after the discovery of minerals, but during the preliminary "development" stage of operation, were required to be capitalized and recovered only through deductions for depletion. Treasury Regulations 111 (1939 Code), Sec. 29.23(m)-15; *Clear Fork Coal Co.* v. *Commissioner*, 229 F. 2d 638 (C.A. 6). The purpose of the 1951 statutory enactment was not to alter the scope of the term "development expenditures," but, rather, to extend their deductibility into the earlier "development" stage of operation. H. Rep. No. 586, 82d Cong., 1st Sess., pp. 30, 107 (1951-2 Cum. Bull. 357, 379, 434-435); S. Rep. No. 781, 82d Cong., 1st Sess., Part 1, pp. 43-44 (1951-2 Cum. Bull. 458, 489).

opment expense, intended to authorize current deduction only of those expenses related to *activity* necessary to make a mineral accessible and not those of acquiring the *right* to carry on such activity. S. Rep. No. 781, 82d Cong., 1st Sess., Part 1, pp. 43–44 (1951–2 Cum. Bull. 458, 489).[2] Other courts have so concluded in similar cases. See, *e.g.*, *Santa Fe Pacific Railroad Co.* v. *United States*, 378 F. 2d 72, 76 (C.A. 7); and *Denise Coal Co.* v. *Commissioner*, 29 T.C. 528, 549–551, affirmed 271 F. 2d 930, 937 (C.A. 3). The facts of record in this case fully support the holding below that the expense at issue was incurred for the *right* to conduct mining operations in the area subject to the utility company's easement rather than for petitioner's *activity* in making the minerals accessible. Consequently, the expenditure was not a development expense within the meaning of Section 616.

2. Petitioner asserts that the decision of the court of appeals here is in conflict with the decision of the United States Court of Claims in *Kennecott Copper Corp.* v. *United States*, 171 Ct. Cls. 580, 347 F. 2d 275. In *Kennecott* the taxpayer used an open pit method

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[2] During the Committee hearings regarding the 1951 legislation, experts called to testify defined "development expenses" in terms such as the following (3 House Hearings before the Committee on Ways and Means on Revenue Revision of 1951, 82d Cong., 1st Sess., p. 1576):

"* * * simply advance costs of mining the deposit. They include such items as shafts, tunnels, haulage drifts, and other underground workings required for access to the ore * * *."

and (*id.*, p. 1609):

"* * * in their nature and purpose to provide the mines with facilities for mining the discovery ore body."

of coal strip-mining which required stripping in concentric circles, with the mining operation located in the center pit. Periodically, it became necessary to widen the center pit and each successive circular step, and Kennecott had frequently been required to destroy and replace its own mining facilities in the process of expanding these circles. 347 F. 2d at 302. In 1948, when the outer circle reached one boundary of Kennecott's property, agreement was reached with the neighboring owner, USSRMCO, to permit continued expansion in that direction. These agreements granted various rights to Kennecott, including the right to strip the surface, but not the fee interest in the adjoining land. As consideration for the granting of these surface rights, Kennecott agreed to pay for replacement of all of USSRMCO's buildings and other facilities destroyed during the expanding mining process, and in fact paid about $14.5 million for these replacements from 1949 through 1955. 347 F. 2d at 276, 278–279, 282. Kennecott did not allocate this amount among the various rights acquired, but treated it as spent entirely for replacing the destroyed facilities. For tax purposes, Kennecott amortized the replacement costs over a nine-year period, 1949–1957, claiming that the cost was deductible in those years as ordinary and necessary expenses of mining under Section 23(a)(1)(A) of the Internal Revenue Code of 1939 and Section 162 of the 1954 Code.[3] 347 F. 2d at 276–278. Alternatively, Kennecott claimed the ex-

[3] Kennecott chose to deduct the expense ratably over the nine year estimated period for the stripping operation on USSRMCO's property. 347 F. 2d at 285.

penses were deductible as development expenditures of a producing mine for 1949 and 1950 (under the pre-1951 statute and regulations, see *supra,* p. 4, note 1), and as development expenditures for later years under the 1951 statutory provision now found in Section 616. Although the Court of Claims noted that "[D]evelopment costs ordinarily relate to active operations rather than access * * *," 347 F. 2d at 299, it concluded, in our view erroneously, that under the particular circumstances, the cost of acquisition of the neighboring surface rights was, at least for one of the years involved, a deductible development expense.

Although there appears to be a conflict in principle between the instant case and *Kennecott,* it is not clear that the Court of Claims would have decided the instant case in taxpayer's favor. The court noted in *Kennecott* that the Internal Revenue Service had never required *Kennecott* to capitalize similar costs for destruction and replacement of its facilities during the early years of its mining operation. Though the court recognized that the Service was not bound by its prior actions, it found "persuasive support" for taxpayer's position in the prior practice. 347 F. 2d at 303–304. Furthermore, the court in *Kennecott* based its interpretation of the term "development expenditures" in part upon an analogy between Kennecott's expense in acquiring access to adjoining property and the cost of an easement for building a mine access road, which it felt would be deductible as part of the cost of constructing the road. 347 F. 2d at 307–308. The Court of Claims has subsequently

recognized that the cost of acquiring an easement is presumptively a capital expenditure subject to recovery through depreciation or, in this case, depletion. *Panhandle Eastern Pipeline Co.* v. *United States,* 408 F. 2d 690; see also *Casey* v. *United States,* 72 U.S.T.C., par. 9419, May 12, 1972.

3. Petitioner asserts (Pet. 12–13) alternatively that it should be permitted to deduct the pipeline relocation costs under Section 162 as an ordinary and necessary business expense, pursuant to the "receding face" doctrine described in Treasury Regulations Section 1.612–2 (Pet. App. 37–38). Under this Regulation, certain *equipment* expenditures necessary to maintain normal output solely because of the recession of the working face of a mine are deductible as ordinary and necessary business expenses. Petitioner admits that since the expense claimed here was not for equipment, it does not qualify for the deduction according to the terms of the Regulations. Petitioner seeks, however, to invalidate the Commissioner's interpretation of the scope of the receding face doctrine to the extent that it excludes the petitioner's expenditure (Pet. App. 13–14). Having failed to question the validity of Treasury Regulations Sec. 1.612–2 in the courts below, petitioner may not do so in the petition for certiorari. *Lawn* v. *United States,* 355 U.S. 339, 362, n. 16.[4] In any

[4] In its brief in the court of appeals (Br. 32), petitioner, referring to the Regulation, stated: "We do not directly rely on that regulation here, as it appears to relate only to expenditures for *equipment* * * *."

event, the Regulation, which recognizes a limited exception to the general rule that capital expenses for mining equipment must be added to the depletable basis pursuant to Section 612, is reasonable and consistent with the statutory scheme, and, accordingly, should be upheld. *United States* v. *Correll,* 389 U.S. 299. Furthermore, while petitioner's expense may have been necessary, it cannot be said to have been an ordinary expense of petitioner's operation, as was found to be the case in *Kennecott, supra.*

4. In spite of the apparent conflict between this case and the decision of the Court of Claims in *Kennecott,* this case is not of substantial present administrative importance. Only one other case is now pending involving this issue—*Cushing Stone Co.* v. *United States,* Ct. Cls. No. 419–70. In that case, the Court of Claims will have an opportunity to reconsider its position in light of the contrary views of the Tax Court and the Sixth Circuit expressed in this litigation, and in light of its recent holding that the cost of obtaining an easement is ordinarily a capital expenditure. See *supra,* pp. 7–8.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

ERWIN N. GRISWOLD,
Solicitor General.
SCOTT P. CRAMPTON,
Assistant Attorney General.
BENNET N. HOLLANDER,
RICHARD HALBERSTEIN,
Attorneys.

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